Rating the Rating Agencies: the State of Transparency and Competition

Testimony
of
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Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee:

On behalf of the Securities and Exchange Commission ("Commission" or "SEC"), I appreciate the opportunity to testify before you today regarding credit rating agencies and their role and function in the operation of the securities markets.

As you know, this past January the Commission submitted to Congress a detailed report on credit rating agencies ("Report")[1] in response to the Congressional directive contained in the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act").[2] The Report was designed to address each of the topics identified for Commission study in the Sarbanes-Oxley Act, including the role of credit rating agencies and their importance to the securities markets, impediments faced by credit rating agencies in performing that role, measures to improve information flow to the market from rating agencies, barriers to entry into the credit rating business, and conflicts of interest faced by rating agencies. As the report called for by the Sarbanes-Oxley Act coincided with a review of credit rating agencies already underway at the Commission, the Report addressed certain issues regarding rating agencies, such as allegations of anticompetitive or unfair practices, the level of diligence of credit rating agencies, and the extent and manner of Commission oversight, that went beyond those specifically identified in the Sarbanes-Oxley Act.

In my testimony this morning, I would like to highlight for you some of the key points in the Commission's Report, and give you a sense of some of the areas we intend to explore in more depth.

Background

For almost a century, credit rating agencies have been providing opinions on the creditworthiness of issuers of securities and their financial obligations. During this time, the importance of these opinions to investors and other market participants, and the

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[1] *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets*, U.S. Securities and Exchange Commission (January 2003) (available at http://www.sec.gov/news/studies/credratingreport0103.pdf).

[2] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 702(b), 116 Stat. 745 (2002).

influence of these opinions on the securities markets, have increased significantly. This is due in part to the increase in the number of issuers and the advent of new and complex financial products, such as asset-backed securities and credit derivatives. The globalization of the financial markets also has served to expand the role of credit ratings to countries other than the United States, where the reliance on credit ratings largely was confined for the first half of the twentieth century. Today, credit ratings affect securities markets in many ways, including an issuer's access to capital, the structure of transactions, and the ability of fiduciaries and others to make particular investments.

During the past 30 years, regulators, including the Commission, have increasingly used credit ratings to help monitor the risk of investments held by regulated entities, and to provide an appropriate disclosure framework for securities of differing risks. Since 1975, the Commission has relied on ratings by market-recognized credible rating agencies for distinguishing among grades of creditworthiness in various regulations under the federal securities laws. These "nationally recognized statistical rating organizations," or "NRSROs," are recognized as such by Commission staff through the no-action letter process. There currently are four NRSROs – Moody's Investors Service, Inc., Fitch, Inc., Standard and Poor's, a division of The McGraw-Hill Companies Inc., and Dominion Bond Rating Service Limited. In the past, the Commission staff has recognized other rating agencies as well, although these firms have since been acquired by existing NRSROs.

Although the Commission originated the use of the term "NRSRO" in regulation, ratings by NRSROs today are widely used as benchmarks in federal and state legislation, rules issued by financial and other regulators, foreign regulatory schemes, and private financial contracts. In this connection, Commission staff recognizes the importance of consulting with other relevant regulatory agencies regarding the role of NRSROs.

To assess whether a rating agency may be considered an NRSRO for purposes of the Commission's rules, the Commission staff consider a number of criteria. The single most important criterion is that the rating agency is nationally recognized, which means the rating organization is widely accepted in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings. Thus, the designation is intended largely to reflect the view of the marketplace as to the credibility of the ratings, rather than represent a "seal of approval" of a federal regulatory agency.

The staff also reviews the operational capability and reliability of each rating organization. Included within this assessment are: (1) the organizational structure of the rating organization; (2) the rating organization's financial resources (to determine, among other things, whether it is able to operate independently of economic pressures or control from the companies it rates); (3) the size and experience and training of the rating organization's staff (to determine if the entity is capable of thoroughly and competently evaluating an issuer's credit); (4) the rating organization's independence from the companies it rates; (5) the rating organization's rating procedures (to determine whether it has systematic procedures designed to produce credible and accurate ratings); and (6) whether the rating organization has internal procedures to prevent the misuse of nonpublic information and whether those procedures are followed. The staff also recommends that the rating agency become registered as an investment adviser under the Investment Advisers Act of 1940.

Recent Commission Initiatives

Over the last several years, the Commission has reviewed a number of issues regarding credit rating agencies and, in particular, the need for a system of regulatory oversight of entities whose credit ratings are to be relied upon for purposes of federal securities regulation. In 1994, the Commission issued a Concept Release soliciting public comment on the appropriate role of ratings in the federal securities laws, and the need to establish formal procedures for recognizing and monitoring the activities of NRSROs.[3] That Concept Release led to a rule proposal in 1997 which, among other things, would have defined the term "NRSRO" in Rule 15c3-1 under the Securities Exchange Act of 1934,[4] the Commission's net capital rule. However, the Commission has not acted upon that rule proposal. We note that the rating agencies take the position that these issues currently are addressed by their existing policies, procedures and competition. In addition, the rating agencies have asserted that their ratings activities are, at least to some extent, protected by the First Amendment.

More recently, the Commission has pursued several approaches, both formal and informal, to conduct a thorough and meaningful study of the use of credit ratings in the federal securities laws, the process of determining which credit ratings should be used for regulatory purposes, and the level of oversight to apply to recognized rating agencies. Commission efforts included informal discussions with credit rating agencies and market participants, formal examinations of each of the NRSROs, and public hearings that offered a broad cross-section of market participants the opportunity to communicate their views on credit rating agencies and their role in the capital markets. Those hearings – held this past November – addressed a wide range of topics, including: (1) the current role and functioning of credit rating agencies; (2) information flow in the credit rating process; (3) concerns regarding credit rating agencies (*e.g.*, potential conflicts-of-interest or abusive practices); and (4) the regulatory treatment of credit rating agencies (including concerns regarding potential barriers to entry).

Commission Report

These Commission initiatives coincided with the requirement of the Sarbanes-Oxley Act that the Commission conduct a study of credit rating agencies and submit a Report on that study to Congress. The Commission submitted that Report to Congress this past January. The Report identified a number of important substantive issues relating

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[3] *See* Nationally Recognized Statistical Rating Organizations, Release No. 34-34616 (August 31, 1994), 59 FR 46314 (September 7, 1994).

[4] *See* Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Release No. 34-39457 (December 17, 1997), 62 FR 68018 (December 30, 1997).

to credit rating agencies that the Commission would be exploring in more depth, including the following: (1) improved information flow in the credit rating process; (2) potential conflicts of interest; (3) alleged anticompetitive or unfair practices by NRSROs; (4) potential regulatory barriers to entry into the credit rating business; and (5) ongoing regulatory oversight of credit rating agencies. As noted in the Report, the Commission plans to issue a Concept Release that would seek public comment on these matters. Among other things, the Concept Release would ask a wide range of questions regarding possible approaches the Commission could develop to address various concerns regarding credit rating agencies.

I will devote the remainder of my testimony to a synopsis of some of these complex issues.

1. *Information Flow*

One important group of issues the Commission staff has been reviewing relates to the information flow surrounding the credit rating process.

First, we are exploring the current amount of disclosure that rating agencies provide regarding their ratings decisions. As you may know, the nature and extent of information made available to the public and/or subscribers varies from one credit rating agency to another. Credit rating agencies may provide comprehensive, lengthy research reports detailing the criteria and support for their ratings, or they may provide less intensive summary information that can be quickly and easily reviewed, or both. At the Commission's credit rating agency hearings, representatives of users of securities ratings – particularly buy-side firms – stressed the importance of transparency in the ratings process. In their view, the marketplace needs to more fully understand the reasoning behind a ratings decision, and the types of information relied upon by the rating agencies in their analysis. Better information about rating decisions, they assert, would reduce the uncertainty, and accompanying market volatility, that frequently surrounds a ratings change.

Second, the Commission staff is reviewing the implications of direct contacts between rating analysts and subscribers. Some have expressed concern regarding the special access subscribers have to rating agency information and personnel. The largest rating agencies generally make their ratings available to the public and subscribers at the same time. As the rating agencies' paying customers, subscribers receive more extensive information and, as a practical matter, many subscribers have direct access to rating agency analysts for elaborative conversations. Questions have been raised as to whether this direct access creates the potential for inappropriate selective disclosure of information (*e.g.,* through the disclosure, intentional or inadvertent, of information concerning a rating prior to its issuance, or regarding the timing or nature of a forthcoming rating change).

Finally, the Commission staff is assessing the extent and quality of disclosure by issuers (including disclosures relating to "ratings triggers"[5]). The accurate appraisal of issuers by credit rating agencies necessarily depends on the ability of rating agencies to access a continuous flow of accurate and reliable information from issuers. Some have questioned whether the level of public disclosure by issuers is adequate. At the Commission's credit rating agency hearings, several specific areas for improved issuer disclosure were mentioned, including the need for additional detail regarding an issuer's short-term credit facilities and, particularly in light of the Enron experience, better disclosure of the existence and nature of "ratings triggers" in contracts material to an issuer.

2. *Potential Conflicts of Interest*

Another set of issues the Commission staff has been examining is the potential conflicts of interest faced by credit rating agencies.

First, the Commission staff is reviewing potential conflicts of interest that could arise when issuers pay for ratings. Concerns have been expressed for a number of years about the potential conflict of interest that arises from the fact that the largest credit rating agencies rely on issuer fees for the vast majority of their revenues. The practice of issuers paying for their own ratings creates at least the potential for a conflict of interest. Arguably, the dependence of rating agencies on revenues from the companies they rate could induce them to rate issuers more liberally, and temper their diligence in probing for negative information. Rating agencies assert that their processes, procedures and market competition sufficiently address these concerns.

Second, the Commission staff is assessing the potential for conflicts of interest to arise when rating agencies develop ancillary fee-based businesses. The large credit rating agencies recently have begun developing ancillary businesses to complement their core ratings business. These businesses include ratings assessment services where, for an additional fee, issuers present hypothetical scenarios to the rating agencies to determine how their ratings would be affected by a proposed corporate action (*e.g.*, a merger, asset sale, or stock repurchase). They also include risk management and consulting services. The development of these ancillary businesses creates another potential conflict of interest for rating agencies. For example, concerns have been expressed that credit rating decisions might be impacted by whether or not an issuer purchases additional services offered by the credit rating agency. In addition, some believe that, whether or not the purchase of ancillary services actually impacts the credit rating decision, issuers may be pressured into using them out of fear that their failure to do so could adversely impact their credit rating (or, conversely, with the expectation that purchasing these services could help their credit rating). Furthermore, in the case of ratings assessment services, there are concerns that, to the extent a rating agency has already "promised" a certain rating to an issuer's hypothetical scenario, pressure to match the actual rating to the

[5] In essence, "ratings triggers" are contractual provisions that terminate credit availability or accelerate credit obligations in the event of specified rating actions, with the result that a rating downgrade could lead to an escalating liquidity crisis for issuers subject to ratings triggers.

promised rating is likely to be forceful, even if the ultimate analysis otherwise might not have supported the rating.

3. *Alleged Anticompetitive or Unfair Practices*

The Commission staff also has been exploring the extent to which allegations of anticompetitive or unfair practices by large credit rating agencies have merit. In the course of the Commission's study, there were a few allegations that the largest rating agencies have abused their dominant position by engaging in certain aggressive competitive practices. For example, Fitch complained that S&P and Moody's were attempting to squeeze them out of certain structured finance markets by engaging in the practice of "notching" – lowering their ratings on, or refusing to rate, securities issued by certain asset pools (*e.g.*, collateralized debt obligations), unless a substantial portion of the assets within those pools were also rated by them. With respect to unsolicited ratings, some also alleged that rating agencies may have used what critics termed "strong-arm" tactics to induce payment for a rating an issuer did not request (*e.g.*, sending a bill for an unsolicited rating, or sending a fee schedule and "encouraging" payment).

4. *Reducing Potential Regulatory Barriers to Entry*

A fourth set of issues under review by the Commission staff is whether the Commission's historical approach to NRSRO designation has created potential regulatory barriers to entry into the credit rating business. For many years, market participants have voiced concerns about the concentration of credit rating agencies in the US. securities markets, and whether inordinate barriers to entry exist. Most agree that significant natural barriers exist, particularly given the longstanding dominance of the credit rating business by a few firms – essentially the NRSROs – as well as the fact that the marketplace may not demand ratings from more than two or three rating agencies. There also has been substantial debate regarding the extent to which any natural barriers to entry are augmented by the regulatory use of the NRSRO concept, and the process of Commission recognition of NRSROs. In essence, the argument is that important users of securities ratings have a regulatory incentive to obtain ratings issued by NRSROs, and that without NRSRO status new entrants encounter great difficulties achieving the "national recognition" necessary to acquire the NRSRO designation. In other words, new entrants are faced with something akin to a "chicken and egg" problem in achieving NRSRO status, which they view as necessary or, at a minimum, very important for becoming a substantial presence in the credit rating industry. Users of credit ratings and others point out, however, that there must be substantive threshold standards for achieving NRSRO status for that term to have meaning.

One obvious way to avoid potential regulatory barriers to entry is to eliminate the regulatory use of the NRSRO concept, and the Commission staff is exploring this possibility. A key issue, of course, is whether better viable alternatives can be found to the current approach of relying on ratings by agencies recognized by the Commission. Further, it must be recognized that, given the widespread use of the NRSRO concept in other federal and state laws and regulations, substitutes would need to be developed by authorities other than the Commission to effectively eliminate any regulatory barriers to entry. We expect to be exploring these issues in depth in the Commission's forthcoming Concept Release.

The Commission staff also is reviewing steps short of eliminating the NRSRO concept that could reduce potential regulatory barriers, including (1) possible clarifications of the current process and criteria for regulatory recognition of rating agencies; (2) instituting timing goals for the evaluation of applications for regulatory recognition; and (3) considering whether rating agencies that cover a limited sector of the debt market, or confine their activity to a limited geographic area, should be recognized for regulatory purposes. In addition, the staff is monitoring the actions of non-U.S. regulators and international bodies, such as IOSCO, in addressing alternative approaches.

5. *Ongoing Oversight*

Finally, the Commission staff is assessing whether more direct, ongoing oversight of rating agencies is warranted and possible and, if so, the appropriate means for doing so. Given the importance of credit ratings to investors, and the influence ratings can have on the securities markets, the staff is considering the implications of a more active Commission role in reviewing the operation of credit rating agencies on an ongoing basis, including jurisdiction, feasibility, resources and other considerations. This oversight could include, among other things, recordkeeping requirements designed for the credit rating business, and a program of regular Commission inspections and examinations. As part of this analysis, we are examining the scope of the Commission's present oversight authority, as well as the potential impact on the credit-rating market of any action the Commission may take.

Another aspect of possible ongoing Commission oversight is whether rating agencies should – and can be required to – incorporate general standards of diligence in performing their ratings analysis, and develop standards for the training and qualifications of credit rating analysts. In the aftermath of the Enron situation and other recent corporate failures, some have criticized the performance of the credit rating agencies, and questioned whether they are conducting sufficiently thorough analyses of issuers, particularly given their special position in the marketplace. Concerns also have been raised regarding the training and qualifications of credit rating agency analysts. Whether and how such standards might be incorporated into the Commission's oversight of credit rating agencies likely will be explored more deeply in our forthcoming Concept Release.

Conclusion

As you can see, credit rating agencies raise a wide range of complex regulatory and policy issues for the Commission. I expect you will get a sense of some of the diverse perspectives on these matters from the witnesses who will be testifying later this morning. The Commission has made substantial progress in its review of credit rating agencies, as I hope is evident from our recent Report to Congress, and I expect our analysis to be focused further based on comments received in response to the planned Concept Release.

Thank you for the opportunity to testify before you today. I would be happy to answer any questions you may have.